PUBLIC CITIZEN Protecting Health, Safety and Democracy

Vote NO on HR 2289, the "Commodity End-User Relief Act"

June 2015

Dear Representative,

Public Citizen urges you to vote NO on HR 2289, the "Commodity End-User Relief Act," which will come before the full House shortly. Several provisions will severely undermine financial reform. These include:

- Adding unworkable cost-benefit analysis requirements that will only empower industry interests to bring litigation that will delay or negate important rules and do nothing to improve Commodity Futures Trading Commission (CFTC) regulations.
- Prohibiting the CFTC from supervising US swap operations overseas, which will invite riskier activity and raise the potential for more bailouts;
- Eliminating the ability of the CFTC to require certain safety rules for swaps.

This bill is a give-away for Wall Street speculators masked as a pro- farmer bill.

The first sentence of the Committee's report explains that this bill "will better protect farmers and ranchers" who use the commodity markets. Yet the text of the 63-page statute itself makes reference to farmers exactly one time, and this comes in only one of the 45 separate provisions of the bill.

In this so-called ranchers-and-farmers bill, however, there *are* lengthy sections helping mega-banks such as JP Morgan engage in synthetic index trades in London, far away from the American heartland. In this bill the committee would have the public understand as aiding the Nebraska sod-buster are provisions designed to help giant commodity processors hide risks off their balance sheets from investors. This bill that claims to provide "relief" is really a headache that American taxpayers must endure as we await the next, inevitable crash from an ill-regulated gambling spree.

The CFTC must be understood as an enforcement agency, not a trade promotion counsel. Its regulations must protect the honest from the dishonest. It should not be a vehicle that maximize profits of speculators who bring dubious social utility to our commodity markets.

Chairman Timothy Massad of the CFTC opposes this bill, as does the White House, where senior advisors would recommend a veto if it arrives on his desk in its present form.

The financial crash awakened Congress to the dangers of the unregulated derivatives market. Agriculture markets otherwise completely unconnected to the housing bubble that blew up the economy suffered seizures; grain elevators stopped forward contracting with farmers and rural banks stopped loaning to elevators, due to extreme price volatility and price levels in commodity derivatives markets, which resulted from excessive speculation by financial institutions. (See studies by and collected through the Institute for Agriculture and Trade Policy.[1])

A bill that emerged from the House Agriculture Committee should have recognized this problem and sought to strengthen oversight. Instead, this measure largely serves the interests of those with the fattest wallets, not those who struggle to repay loans.

New Cost-Benefit Requirements Don't Pass the Cost-Benefit Test

Wall Street has exploited the courts to delay, dilute and even overturn needed reform laws intended to return the financial industry to safer practices. Instead of making the CFTC more effective and efficient by bolstering their authority and improving their standing vis a vis the courts, this bill actually makes the CFTC even more vulnerable to Wall Street lawsuits. The net effect will be weaker rules that will take the CFTC longer to finalize and will be more prone to reversal in court. In sum, this legislation will significantly damage, not improve, the CFTC's ability to adopt strong financial reforms that protect consumers and the public.

This measure requires in Section 204 that the full commission select the Chief Economist who will be the head of the Office of the Chief Economist. This constitutes a significant departure from current practice whereby the Commission chair selects senior staff. Public Citizen generally believes that law enforcement agencies are best governed by a single, accountable director. In this way, decisions can be forceful and efficient. Where these decisions prove ill-founded, this director can be held to account. The accountability for decisions rendered by a commission is cloudy, with each commissioner able to escape responsibility. With the ability to select senior staff, both the efficiency and accountability of Commission decisions rests more with the chair. A commission-based selection process will necessarily introduce friction into this process as individual commissioners would now be able to block candidates that don't conform to their special views.

The legislation then confounds the rule-making process by requiring this newly politicized Chief Economist subject to the control of all five commissioners to undertake an unworkable slate of analyses. In Section 202, the Chief Economist would be required to consider 11 separate features of any proposed rule. For example, the Chief Economist must explain whether the chosen rule would "maximize net benefits." This requires a review of all potential options, a number that conceivable approaches infinity. Included in this consideration of maximum net benefit is "equity," a concept of judgment that is hardly amenable to quantification. Another requirement is that the Chief Economist must address "other public interest considerations." Such an open-ended requirement would be almost impossible to satisfy. Commissioner Giancarlo once expressed concern about regulation affecting an aluminum smelter, and wondered if the commissioner were prepared to force American defense contractors to source this metal from abroad, suggesting a threat to national security.[2] Under this provision, failure to consider national

[1] See the annotated bibliography of about a hundred studies compiled by Markus Henn, "Evidence on the Negative Impact of Commodity Speculation by Academics, Analysts and Public Institutions," November 26, 2013, WEED. Available at http://www2.weed-online.org/uploads/evidence_on_impact_of_commodity_speculation.pdf .

[2] See "A Matter of National Security (and Beer,) by Bartlett Naylor, (November 2014), available at: http://www.huffingtonpost.com/bartlett-naylor/a-matter-of-national-security-and-beer_b_6122192.html

defense might be an “other consideration,” where the failure to address could expose the commission to litigation. Since the CFTC also oversees commodities involving food, is the Chief Economist supposed to consider America’s eating habits?

Failure to address these considerations would be subject to litigation by industry members unhappy with the rule, as provided in Section 210. This provision empowers a court to negate a rule if the industry can show it was “without observance of procedure required by law.”

Further, there is a bias in these 11 “considerations” to consider only the cost as opposed to the benefits of safeguards. The CFTC exists to protect the economy from abuses, including a revival of the cataclysm from unregulated swaps activity that devastated the economy beginning in 2008.

Finally, this measure patently ignores the fact that the CFTC takes their cost-benefit requirements very seriously. In September 2010, the CFTC’s General Counsel and Acting Chief Economist directed staff to produce cost-benefit analyses in proposed rulemakings and conceptual cost-benefit analyses in adopting releases. This is above and beyond existing CFTC requirements. In a follow-up memo, rule-making teams were directed to “incorporate the principles of Executive Order 13563” when writing rules. This order applied cost-benefit analysis requirements for departments overseen by the President. In May 2012, the CFTC, in an unprecedented move, entered into a memorandum of understanding with the Office of Information and Regulatory Affairs (OIRA) where OIRA provides “technical assistance” to CFTC staff during implementation of the Dodd-Frank Act, “particularly with respect” to cost-benefit analysis.[3]

Thus, the litany of additional cost-benefit analyses imposed by this bill in no way improves the existing and extensive cost-benefit analysis practices at the CFTC. Rather the direct effect will be to convert the cost-benefit analyses the CFTC already conducts as a matter of best practice into numerous new legal grounds for Wall Street to challenge CFTC rules in court. Thus, the beneficiaries of these changes will be big Wall Street banks and their high-priced lawyers while the public pays the price of a far slower CFTC that must jump through even more hoops before putting common-sense Wall Street reforms in place.

Evading US Supervision

Some of the most dangerous financial practices by US firms leading to the financial crisis of 2008 were conducted through overseas affiliates of US parent companies. AIG sold a form of bond insurance called credit default swaps from its London office, out of view of American supervisors. When AIG could not pay massive claims from bond defaults, taxpayers bailed out AIG’s clients with $160 billion. More recently, JP Morgan’s “Whale” transactions used US deposits for speculative derivatives trading in London, leading to a loss of more than $6 billion.

Section 314 provides that derivatives legally booked in any of the world’s 8 largest derivatives markets would be exempt from US supervision. Only if the CFTC proves that the results of the rules and supervision in these foreign jurisdictions are inadequate could the US agency assert US oversight. This section actually permits the personnel arranging the derivatives to be located in the US.

Permitting foreign supervision is misguided because foreign supervisors won’t have the same motivation as US supervisors to enforce prudential rules since a failure would fall on US taxpayers. In fact, foreign governments would be incentivized to relax oversight so as to attract more traders and the associated

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[3] Memorandum of Understanding, OIRA, CFTC, (May 2012), available at: http://www.whitehouse.gov/sites/default/files/omb/inforeg/regpol/oira_cftc_mou_2012.pdf

income tax revenue they would generate. The financial sector provides more than 11 percent of total tax revenue for the United Kingdom.[4] Not only does this legislation increase the chance for another US taxpayer bailout, it sacrifices US tax revenue by incentivizing American firms to relocate their derivatives business abroad.

Safety margins prohibited

Unregulated swaps were at the heart of the financial crash, as derivatives dealers who failed to back up their swaps with adequate collateral spread financial contagion. This legislation removes some of the tools that the CFTC could use to promote safety. For example, this bill prohibits the CFTC from requiring that end-users post margin collateral. The CFTC has declared that it would not require such margin, but it is important for the agency to retain this power if the market becomes unsafe in the future.

In reality, swap participants do require margin. The International Swap and Derivatives Association reports that 91% of all OTC derivative traders are subject to collateral agreements. [5] In the cases where cash collateral is not posted, the commodity hedger is likely using an off-balance sheet contingent line of credit.[6] That means that collateral is effectively the same asset collateral that the company could otherwise use to raise capital. In other words, the cost to the company is the same. In the case of off-balance sheet collateral, however, this cost is masked from investors.

Moreover, this permission to hide liabilities from shareholders only applies to the largest companies. Small farmers who hedge don't engage in OTC derivatives. They use the futures exchanges that require cash collateral.

These are but a few of the flaws of this bill. There are many other sections that limit the ability of the CFTC to accomplish its mission of protecting investors and the public from misconduct in the $700 trillion swaps market. We believe Congress should be exploring ways to strengthen the agency, such as with self-funding and a larger budget, rather than working to undermine it.

We urge the House to reject this measure.

For more information, please contact Public Citizen's Congress Watch Advocates: Amit Narang, Regulatory Policy Advocate at anarang@citizen.org; or Bartlett Naylor, Financial Policy Advocate, at bnaylor@citizen.org.

Sincerely,

Public Citizen

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[4] "Total Tax Contributions of UK Financial Services," City of London Corp. (December 2013), available at: 7http://www.cityoflondon.gov.uk/business/economic-research-and-information/research-publications/Documents/research-2013/total-tax-contribution-of-uk-financial-services-sixth-edition.pdf

[5] See ISDA survey, available at: https://www2.isda.org/functional-areas/research/surveys/margin-surveys/

[6] Dr. John Parsons explains this with an example of Exelon energy , available here: http://bettingthebusiness.com/2012/08/03/exelons-on-and-off-balance-sheet-collateral-costs/